Defined Contribution pension investment into illiquid assets

The BVCA was delighted to join HMT's Patient Capital Pension Investment Taskforce earlier this year. We support the ultimate goal of increasing the supply of patient capital in the UK economy, including tackling the continuing barriers holding back DC pension savers from investing in illiquid assets. The work of the Taskforce has been valuable in identifying these barriers and we will need to work together, as market participants and policymakers, to enable this investment.

The shift from Defined Benefit ("DB") plans to Defined Contribution ("DC") plans that is currently underway in the UK pension sector is affecting the range of investment opportunities available to pension holders and the level of funding in venture capital and private equity funds. This in turn could affect initiatives such as the British Patient Capital and Managed Funds programmes which are seeking to catalyse and drawn in investment from institutional investors such as UK pension funds. The latest BVCA data shows how little capital was raised from UK pension funds by UK-based venture capital and private equity funds in 2017 – just 3.7% of the £33 billion raised was from UK pension funds, whereas 36.5% came from overseas pension funds[1] (note that this number will not include fund managers that are not based in the UK). Breaking this down a different way, the majority of the 36.5% was from overseas public pension funds at £10.5bn or 31.7% of the total £33bn raised. Data on the global pensions markets in 2017 from Willis Towers Watson[2] showed that the UK has the second biggest pensions market in the world with $3.1 trillion of pension assets. 28% of this amount was allocated to other asset classes including alternatives. The DB to DC pensions assets split was 81% to 19%. Therefore there is potential for UK managers to raise more capital from UK pension funds in the future.

The most appropriate measure of the long-term performance of venture capital and private equity is on a since-inception basis, and under this metric, our latest performance measurement survey shows that UK funds continue to demonstrate a high level of persistence and consistency in performance, with returns tending to hover in a band of approximately 15% over the past decade[3]. To complement our performance measurement survey, there is US research that shows how allocations to private assets can improve investment performance:

- Data from US endowments and foundations provided to Cambridge Associates LLC[4] showed that portfolios with more than 15% allocated to private investments have outperformed their peers consistently, and for decades. Cambridge attributed the outperformance to venture capital, private equity, and distressed securities far outperforming public asset classes, earning annualized returns of 12.5%, 11.9%, and 10.8% respectively over the last 10 years.

- Analysis performed in 2013 by Willis Towers Watson[5] looked at the asset allocations of a subset of large plan sponsors for 2010 and 2011, comparing DB and DC plan performance to simulated investment returns. Using an asset-weighted measure of returns, DB plans outperformed DC plans by an annual average of 76 basis points from 1995 to 2011. The report noted that DB plan sponsors have been replacing equities with more fixed-income and alternative investments to diversify their investment portfolios and better match assets to liabilities.

---

[1] BVCA report on Investment Activity 2017 – available here
[2] Global Pensions Assets Study 2018 – available here
[3] BVCA Performance Measurement Survey 2017 – available here
[4] The 15% Frontier, July 2016 - available here
[5] Insider, May 2013 – available here

British Private Equity & Venture Capital Association
5th Floor East, Chancery House, 53-64 Chancery Lane, London WC2A 1QS
T +44 (0)20 7492 0400 F +44 (0)20 7492 0401 bvca@bvca.co.uk www.bvca.co.uk

Our feedback and key recommendations are below:

- As noted above, the Government must continue to fund the British Business Bank/British Patient Capital, including the Managed Funds Programme, to support the broader venture, growth and lower mid-market funds industry in the UK.

- Innovation from the new generation of platforms and DC providers should be embraced, including looking at the approach taken in other countries. The FCA's work on Permitted Links and how DC pension schemes can manage an element of illiquid investment within their funds is just one part of the overall solution. The UK needs a new fund vehicle that gives investors the structure they need to invest into illiquid asset classes, such as the US collective investment trust. Further detail on this is below and the BVCA can support the work on this new fund structure.

- The forthcoming guidance from The Pensions Regulator on investing in illiquid assets is welcomed, as are other initiatives to improve trustee training and guides with case studies on how pensions invest in venture, growth and lower mid-market funds. These initiatives should help to demystify what it means to invest in the asset class and help trustees to understand returns and costs entailed. The work of the FCA's Institutional Disclosure Working Group and its successor will also provide guidance and templates for capturing fee and cost information. The BVCA has been a key contributor to this work.

- From a commercial perspective, any guidance for trustees must cover returns and performance, as well as the costs of investing in the asset class. As highlighted above, the BVCA does collect data to measure performance of UK-based funds. This survey is already unique in its scope and can become even more valuable if more firms are encouraged to provide data. It will help to move the debate on from solely focusing on fees to one that looks at net returns and fees together.

- As more money has flowed into DC schemes, fund managers have adopted default investment options for the members. Defaults have many of the characteristics of a DB fund insofar as they are managed by professionals and invest across a range of asset classes over the long-term, with specific targets in mind. In the US, default options can be very large and highly customised to meet the specific needs of the sponsor's workforce. This bespoke approach facilitates investments in alternatives, which can be mingled with other liquid asset classes so that they are sheltered from the individual participants' contributions and withdrawals. Therefore the challenges around original investment (removing the J-curve effect), fees, regular pricing and liquidity are not insurmountable with careful portfolio construction and planning:

    - The growth of the industry means there are more opportunities to invest into secondaries funds. In the early years of a product, managers can use secondaries and co-investments alongside primary fund investments to reduce/eliminate the impact of the J-curve.

    - Policies can be developed to calculate fair value between quarterly valuation cycles. Furthermore, there is DC investment in other hard-to-value assets such as emerging market debt so the framework for pricing such investments does exist.

    - Multi-asset vehicles/structures and "target (retirement) date" products in the US offer ways to reduce overall fee burdens and provide liquidity. Illiquid assets can form a small part of the overall portfolio to address the need for cash to fund drawdowns and meet other liquidity requirements, and work within the constraints of the current charge cap. The current charge cap is too low for the type of active investment needed in patient capital. This might be mitigated if illiquid assets are a small part of the overall portfolio and if carried interest could be excluded from the cap as it is a profit share.

Changes to Charging Cap

As you are aware, the structure of any default funds held in an automatic enrolment pension plan must be such that member-borne administration charges are no greater than 0.75% of the member's rights over a 12 month period. The cap means that higher fees/charges on private asset investments must be counterbalanced by lower charging investments in a default fund. However, the nature of private equity funds (including the carried interest model, whereby carried interest payments are potentially unlimited in amount, albeit typically only paid after the fund has returned investors' capital plus a preferred return) causes some DC schemes to be cautious about this area. The Government announced in November 2017 that it would not make an adjustment to the cap at present but committed to review this again in 2020. We would very much welcome a review and in particular would appreciate some guidance for DC schemes about (a) counter-balancing higher fees/charges on private asset investments against lower charging investments and (b) the application of these requirements to performance based fees.

Changes to Permitted Links Rules

As mentioned above, we welcome the FCA's work on Permitted links rules (FCA COBS 21.3). The existing rules effectively impose restrictions on the classes of assets ('permitted links') which DC schemes can hold (the rules do not apply to Defined Benefit schemes). Permitted links include unlisted securities, but the liquidity requirements (they must be realisable in the short term) act as an effective barrier to investment in this asset class. We welcome the FCA's comment that a DC scheme may be able to invest in illiquid securities by balancing such investments against liquid assets held by the scheme in order to manage its liquidity requirement, but there is continuing uncertainty on this point which may cause DC schemes to be cautious. Permitted links also include UCITS, NURS (not useful for private assets) and QISs (up to 20% of the scheme) and unregulated schemes. However, in order to be a permitted link, QISs/unregulated schemes must themselves invest only in permitted links, which makes investment in private assets difficult, particularly on a global basis. Rule changes and/or guidance in relation to the permitted links are an important, albeit not the only solution.

Changes to Product Regulation

We believe that restrictive product regulation operates today as an effective barrier to investment by DC schemes in private assets. Noting that DC schemes are driven by the need for liquidity to invest in open-ended funds, we have focused our attention on authorised funds, with which DC schemes are most familiar.[6]

[6] There are other possible vehicle choices. For example, private limited partnerships could be used as open-ended structures, since the recent change in law permitting repayment of capital by private limited partnerships. However, DC schemes are considerably less familiar with these sorts of vehicles and in any event, the tax treatment of limited partnerships may not be attractive to DC schemes.

We believe that removing the restrictions applicable to existing categories of authorised funds (UCITS, NURS, and QIS) or by creating an entirely new category of investment vehicle to which none of these restrictions apply would be an important part of the overall solution. This is discussed below in relation to each of UCITS, NURS, and QIS.

UCITS. A UCITS scheme is generally not suitable as an investment vehicle with a core strategy of investing in private assets. In particular, a UCITS scheme may not invest more than 10% of the scheme property in transferable securities which are not admitted to, or dealt in, on an eligible market; and may not invest more than 30% of its value in non-UCITS collective investment schemes (and even then, the non-UCITS schemes must be NURS or equivalent). Other investment restrictions, for instance in relation to the valuation and transferability of investments, the use of derivatives, and borrowing restrictions, may be problematic.

NURS. A NURS is generally not suitable as an investment vehicle with a core strategy of investing in private assets. In particular, a NURS scheme may not invest more than 20% of the scheme property in transferable securities which are not admitted to or dealt in on an eligible market; may not invest more than 20% of its value in collective investment schemes which are not UCITS, NURS or equivalent, unless it is established as a NURS fund of alternative investment funds (FAIF). The 20% buckets are unhelpful for investment vehicles with a core strategy of investing in private assets and consequently limit investor choice. Moreover, the NURS may only invest in unregulated schemes (even if it is established as a FAIF) if the participants in such schemes are entitled to have their units redeemed at net asset value. This therefore precludes any investment at all in any closed-ended funds (thus ruling out a NURS for a funds of funds even though funds of funds are more diversified and consequently have a lower risk profile than say a fund investing directly in securities of underlying companies). Other investment restrictions, for instance in relation to the due diligence requirements, valuation and transferability of investments, the use of derivatives, and borrowing restrictions, may be problematic.

QIS. A QIS does not impose the same percentage limitations as described above on investments in unquoted equities (meaning that it could be a viable solution for a private equity fund investing directly in unquoted securities). Similarly, for funds of funds, there is more flexibility in percentage terms with respect to investments in unregulated collective investment schemes. However for managers of funds of funds, there are onerous due diligence requirements for the manager to undertake in relation to the target portfolio fund, both pre-investment and on on-going basis. Guidance on this is detailed and may not be practical to follow, especially in context of, say, secondary fund acquisitions (where access to the underlying portfolio fund manager may be restricted). In particular, many of the due diligence requirements seem duplicative in relation to an existing EEA Alternative Investment Fund managed by a full scope EEA Alternative Investment Fund Manager. Moreover, we observe that there is a general lack of familiarity with the QIS model as the NURS is more commonly used in the market.

In conclusion, we would suggest that alleviating these restrictions and / or creating a new category of investment vehicle to which these restrictions would not apply would facilitate investment by DC schemes in private assets.